Developments in limited liability companies

Limited liability companies continue to grow in popularity as a choice of business entity. The combination of limited liability, pass-through tax treatment if partnership treatment is elected, ability of members to be actively involved in the management of the business, and lack of many of the restrictions imposed on S corporations have made it a very attractive from of entity.

Still, as the new kid on the block, LLCs have continued to suffer through a few growing pains as states modify their LLC status and the Internal Revenue Service ("IRS") tries to figure out how best to deal with these entities while limiting the potential for abuse.

Some of the issues that the IRS has been trying to deal with include the extent to which members of an LLC taxed as a partnership should be treated as similar to general partners or limited partners. Members possess the limited liability of limited partners, but often have the management responsibilities of general partners. LLCs and partnerships share the issue of how a profits interest in the LLC or partnership given for services rendered to the LLC of partnership should be taxed. Traditionally, such interests were taxed as capital interests, but there is a growing belief on Capitol Hill that, at least in certain circumstances, ordinary income treatment is more appropriate.

Single-member LLCs have also become a growing concern for the IRS. Generally disregarded for federal tax purposed but recognized as separate entities under state and foreign law, the IRS believes that this dual status has permitted single-member LLCs to be used improperly in abusive tax shelter transactions.

THOMPSON AND GARNETT CASES

The IRS has generally taken the position that limited liability members should be treated like limited partners due to the shared characteristic of limited liability. The IRS has therefore treated LLC losses passed through to members as passive losses subject to the passive-loss rules. The IRS has lost on that position in two significant cases this year: the Garnett case in the Tax Court and the Thompson case in the Federal Court of Claims. Those courts focused more on the degree of active participation of the member in the business to determine whether the passive-loss rules applied, rather then the limited liability status. The IRS has not conceded those cases, but is looking at the entire issue of how LLC members should be treated under various provisions of the Tax Code.

Although a taxpayer victory, some practitioners are cautioning that this apparent victory could turn out to be a negative when looking not at losses being distributed by an LLC, but instead at gains distributed by an LLC. If the IRS starts to view those gains as also being associated with the degree of participation in the business, the IRS may take the position that those gains are subject to self-employment taxes.

THE PIERRE CASE

In Pierre, the IRS asserted that, where an LLC treated as disregarded entity is involved, a gift of an interest in the LLC must be treated as a gift of the underlying assets in the LLC for gift tax purposes. The Tax Court this year rejected this position, starting that your must look to state law for a determination of gift tax treatment, and the LLC was a valid entity under state law. The IRS has, in the past, achieved victories in this area, and a dissenting opinion in Pierre stated that the majority was ignoring the plain language of the check-the-box regulations. Do not expect the agency to roll over on this one.

LLCs have become a popular alternative to partnership structures in estate planning with family limited partnerships. The IRS continues to attack many family limited partnership structures, and achieves a fair number of victories due usually to bad facts; failure to complete all aspects of the transaction, lack of business purpose for the transfers, failure to respect the integrity of the entities that have been set up, and failure to provide for adequate support for the transferor.

However, properly structured family limited partnerships using LLCs remain a valid estate-planning technique. Some legislative proposals would restrict the valuation discounts that could be obtained from family limited partnerships. Most professionals feel that family limited partnerships would survive as valuable estate planning vehicle even without valuation discounts.

SERIES LLCS

A growing number of states are modifying their LLC statutes to permit series LLCs, under which each asset is typically put in a separate LLC to protect each asset from liabilities associated with other assets, but all of the LLCs operate under a master LLC that is the filing and tax-paying entity under state law. The IRS's treatment of series LLCs is still under review, and, as was the case with LLCs themselves, the wide use of series LLCs may have to wait until the agency clarifies how they will be treated for tax purposes and until they become more widely adopted by various states.

Some issues currently before Congress could impact the tax treatment of LLCs. Although the check-the-box regulations permitted a taxpayer to elect whether an LLC would be treated as a partnership or a corporation, congressional proposals would eliminate that election in the case of a foreign single-member LLC, forcing it to be treated as a corporation. Taxpayers have been taking advantage of the different treatment of LLCs under foreign and U.S. law to obtain favorable tax results that the IRS considers abusive. Check-the-box would remain available for domestic LLCs.

Legislation also before Congress proposes taxing a partner's or LLC member's profits interest allocable to the performance of services at ordinary income rates. Some proposals have had more restrictive provisions, focusing primarily on hedge fund managers. The Obama administration, however, included the broader provision in its FY 2010 budget proposal. The Obama administration believes that it is better for all taxpayers to be taxed at ordinary income rates for the services that they perform than for the tax rate to be dependent on the form of entity chosen.

A return to higher marginal tax rates in 2011 for individuals while the top corporate tax rate remains at 35 percent, or perhaps an even lower corporate tax rate if enacted under some proposals, could lead to a rethinking of the advantages of pass-through entity treatment, particularly in the dividend tax rate remains at the capital gain rate, rather than returning to the ordinary income rate. The LLC structure provides the flexibility, however, to elect to be taxed as a corporation, rather than a partnership, without changing the basic structure of the entity.

SUMMARY

While there are a significant number of tax issues with respect to LLCs that are still somewhat up in the air, many of those tax issues do not impart the basic operation of a domestic multi-member LLC. The basic attractiveness of the LLC form is not likely to be significantly diminished by the current issues facing LLCs. Some may be resolved by making LLCs even more attractive. Others may prove to be adverse, but either will not affect the vast majority of LLCs or will not be damaging enough to offset the basic advantages that LLCs offer.